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***EX PARTE* – Electronically Filed**

Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *Verizon Petition for Forbearance from the Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) of the Commission's Rules*, CC Docket 96-149

Dear Ms. Dortch:

I am writing to respond to Verizon's May 15, May 19, June 4, and June 24, 2003, *ex parte* filings regarding the "costs" that are purportedly caused by the Commission's rules that prohibit the sharing of operating, installation, and maintenance ("OI&M") services between a Bell operating company ("BOC") and its section 272 separate affiliate. As explained below, and in more detail in the accompanying declaration of Dr. Lee L. Selwyn ("Selwyn *Ex Parte* Dec."), Verizon's "cost study" is largely unverifiable *ipse dixit*. But even with regard to the few details that Verizon reveals, it is clear that Verizon's cost study can be given no weight. Verizon has apparently made no attempt to determine the overall firm-wide "costs" of the OI&M rules, but has simply calculated how much its section 272 affiliate would purportedly save if Verizon's BOCs were able to provide OI&M on its behalf – ignoring altogether the corresponding cost *increases* that the BOC would incur in taking over these functions. In other words, Verizon assumes that its BOC could provide *for free* the very same OI&M services that Verizon claims impose such enormous costs on its section 272 affiliate.

The Commission should not be bullied into overlooking Verizon's failure – in the eleven months since it filed its Petition – to support its claims that the OI&M safeguards are too costly to justify the clear public interest benefits that they provide. To the extent that the costs to Verizon are relevant, there remains ample time for Verizon to perform and submit proper cost studies that the parties and the Commission can then evaluate. Contrary to Verizon's claims, there is *no* impending statutory deadline for the Commission to act on Verizon's Petition. As the Commission has made clear, the 12 to 15 month statutory deadline imposed by section 10(c) of the Communications Act, 47 U.S.C. § 160(c), applies *only* to petitions that comply fully with the Commission rule governing the filing of such forbearance petitions, and Verizon's petition plainly does not comply with that rule. Commission Rule 1.53 states in full:

> In order to be considered as a petition for forbearance subject to the one-year deadline set forth in 47 U.S.C. § 160(c), any petition requesting that the Commission exercise its forbearance authority under 47 U.S.C. § 160 *shall* be filed as a separate pleading and *shall be identified in the caption of such pleading as a petition for forbearance under 47 U.S.C. § 160(c).* Any request which is not in compliance with this rule is deemed *not* to constitute a petition pursuant to 47 U.S.C. § 160(c), and is *not subject to the deadline set forth therein*.[1]

Verizon did not caption its Petition with the required reference to 47 U.S.C. § 160(c).[2] That is why the Public Notice issued by the Commission makes no mention of 47 U.S.C. § 160(c) in either the caption or the description of Verizon's Petition.[3] The statutory period for Commission decision will not even begin to run unless and until Verizon files an OI&M forbearance Petition that complies fully with Rule 1.53. Thus, the Commission need not cut short its evaluation of the continued need for OI&M safeguards – and could, for example, consider that issue as part of its broader ongoing consideration of the appropriate regulation of BOC long distance services.[4] And the Commission therefore should – indeed, must – reject any suggestion that superficial treatment of the cost issues raised by Verizon could be justified as necessary to meet a statutory deadline for decision.

Although the Commission could not, on this record, rationally grant the Petition, there are ample grounds to deny it now. As an initial matter, section 10(d) (47 U.S.C. § 160(d)) precludes the Commission from forbearing from the OI&M requirements in these circumstances.

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[1] 47 C.F.R. § 1.53 (emphasis added). *See also* 65 Fed. Reg. 7460 (Feb. 15, 2000) (due to "concern[] that the Commission and interested parties may not have sufficient opportunity to consider [forbearance] requests in a timely manner" if they are not "readily identifiable," Rule 1.53 requires forbearance petitions to be "clearly identified in the caption as a petition for forbearance under section 10(c) of the Act").

[2] Instead, Verizon chose to caption its petition merely as the "Petition of Verizon for Forbearance From the Prohibition of Sharing Operating, Installation, and Maintenance Functions under Section 53.203(a)(2) of the Commission's Rules." *See* Verizon Petition for Forbearance (CC Docket No. 96-149, Aug. 5, 2002). Verizon knows how to caption its pleadings when it wants to trigger the statutory deadlines. *See* Petition for Expedited Forbearance of the Verizon Telephone Companies, at 1 (WC Docket 03-157, July 1, 2003).

[3] Public Notice, DA 02-1989 (Aug. 9, 2002).

[4] *See* Notice of Proposed Rulemaking, *In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate And Related Requirements* (WC Docket No. 02-112, May 19, 2003).

Specifically, section 271(d)(3)(B) provides that the Commission may grant a BOC long distance authority only if the requested authorization "will be carried out in accordance with the requirements of section 272" of the Act. Verizon's Petition would thus require the Commission to forbear from applying section 271(d)(3)(B), because it would be seeking to provide interLATA services without having to comply with section 272(b) "operate independently" requirement that the OI&M rules implement. Section 10(d), however, expressly prohibits the Commission from forbearing from section 271 until that statute is "fully implemented" – a demanding standard that Verizon does not even claim to satisfy.[5]

Finally, as I explain in addressing specific questions posed to AT&T by the Commission's Staff, there are additional reasons why Verizon's petition should be denied. The record in this proceeding – as well as the numerous other proceedings in which the Commission has investigated the ability of the BOCs to leverage their bottlenecks into downstream markets – is clear that "[a]llowing a BOC to contract with the section 272 affiliate for operating, installation and maintenance services would inevitably afford the affiliate access to the BOC's facilities that is superior to that granted to the affiliate's competitors."[6]

I. VERIZON'S "COST" STUDIES

At the outset, it must be recognized that Verizon's cost evidence is legally irrelevant. Even if the Commission had discretion to forbear from section 271(d)(3)(B) and relieve Verizon of incorporated section 272 obligations, any claim that compliance with section 272 is "costly" does not advance Verizon's cause. Under section 10, forbearance requires an assessment of whether enforcement of the OI&M rules are "necessary" to prevent "unjust[] and unreasonably discriminatory" practices by Verizon,[7] and whether these regulations are "necessary" "for the protection of consumers."[8] No matter how costly compliance with the OI&M safeguards is claimed to be (and the record does not support Verizon's claims that the costs are in fact substantial), so long as there is a "strong connection" between those safeguards and the protection of long distance competition, they are "necessary" within the meaning of Section 10 and forbearance may not be granted.[9]

In all events, as Dr. Selwyn explains in the accompanying *ex parte* declaration, Verizon's "cost study" is baseless. Despite having had nearly a year to document its claimed cost savings,

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[5] *See Ex Parte* Letter from David Lawson, Counsel for AT&T, to Marlene Dortch, FCC (CC Docket No. 96-149, July 9, 2003).

[6] *Non-Accounting Safeguards Order*, 11 FCC Rcd. 21905, ¶ 163 (1996).

[7] 47 U.S.C. § 160(a).

[8] *Id.* § 160(a)(2).

[9] *Cellular Telecommunications & Internet Assoc. v. FCC*, No. 02-1264, slip op. at 17 (D.C. Cir. June 6, 2003).

Verizon has yet to have done so. Rather, the core of Verizon's "analysis" is a table that lists the percentages of expenses for various categories (*e.g.*, OSS, workforce) that Verizon claims are driven by the Commission's OI&M rules.[10] Verizon then applies these arbitrary figures to the total expenses Verizon claims that its section 272 affiliate (GNI) incurs for each expense category, with the results of that multiplication being the claimed overall "cost savings." Verizon provides no explanation as to how these percentages were derived other than to say that they were based on "assumptions" by "subject matter experts."[11] As a result, there is no way to test any of Verizon's assumptions, such as, for example, labor rates, capital costs, depreciation lives, and, most critically, whether the costs in question are actually "driven" by section 272 and the prohibition on OI&M sharing in particular. Nor is there any way to ascertain whether Verizon correctly and properly performed the mathematics it claimed to have undertaken. The Commission has made clear that such unverified *ipse dixit* does not establish "any record basis" to support agency action.[12]

But even the limited detail provided by Verizon exposes that its study is fundamentally flawed. To arrive at the "savings" from the elimination of the OI&M restrictions, Verizon simply calculated (in the flawed manner discussed above) the reduction in costs that GNI would achieve if the Verizon BOCs performed all OI&M-related activities currently performed by GNI. For example, Verizon states without explanation that the majority of OSS expenses for GNI are "driven" by section 272. On the other hand, nowhere does Verizon discuss the increased costs that it would incur by having its incumbent LEC operations perform the tasks that its 272 affiliate personnel previously performed. In other words, Verizon appears to have myopically focused only on the cost savings that the 272 affiliate would achieve from having the incumbent LEC provide OI&M on its behalf, without making any attempt to determine how *overall* firm-wide costs would be changed.[13]

Although Verizon is cagey on this point, it appears to justify this approach by claiming that the BOC has so much excess capacity that it could "absorb" the incremental work without any incremental cost.[14] This claim is astonishing. Verizon and the other BOCs have repeatedly claimed that "price cap" regulation ensures that they are operating efficiently. To the extent that

[10] *See* Selwyn *Ex Parte* Dec. ¶¶ 3-4.

[11] *Ex Parte* Letter from Dee May, Verizon, to Marlene Dortch, FCC, at 6 (CC Docket No. 96-149, June 24, 2003) ("Verizon June 24, 2003 *Ex Parte*").

[12] *E.g.*, *AT&T Corp. v. Business Telecom, Inc.*, 16 FCC Rcd. 12312, ¶ 49 (2001).

[13] Selwyn *Ex Parte* Dec. ¶¶ 5-10. This is highlighted by the fact that Verizon asked only GNI employees to determine the level of costs savings that GNI would achieve from eliminating the OI&M rules; no comparable request was made of Verizon incumbent LEC employees as to how much additional work would be necessary to handle functions formerly being handled by GNI.

[14] Verizon June 24, 2003 *Ex Parte* at 7.

Verizon is maintaining excess capacity in its work force, systems, and other resources that is sufficient to absorb fully the additional OI&M demands of GNI, that is conclusive evidence that price cap regulation is not working as intended – and that Verizon has strong incentives to misallocate costs to its regulated local services.[15] Clearly, cost "savings" that are achieved only because of existing inefficiencies in Verizon's network operations are not a basis for eliminating the OI&M rules. And on the relevant issue of how much elimination of the OI&M rules would save a reasonably efficient carrier, Verizon has nothing to offer.

In any event, Verizon's claims regarding the costs of structural separation are undone by its own actions. Verizon has *voluntarily* created five different section 272 affiliates, each with its own OI&M resources, despite having a statutory obligation to create only one. Indeed, two of these affiliates, Verizon Global Solutions and Verizon Global Networks, Inc., apparently own switching facilities in the same cities.[16] That Verizon would have voluntarily chosen this structure gives the lie to its unsupported claims that the OI&M rules impose prohibitive costs. At a minimum, Verizon would need to prove that significant cost savings could not be achieved by integrating the five separate 272 entities into one single unit.[17]

II. ADDITIONAL ISSUES RAISED BY COMMISSION STAFF

In AT&T's May 2, 2003, meeting with the Commission's Staff, AT&T was asked to address several additional issues raised by Verizon's Petition. Each is addressed below.

The Record On OI&M Safeguards. Verizon claims that, when the OI&M safeguards were first "adopted, the Commission did not have a record to conduct a cost-benefit analysis of using structural separation as opposed to accounting safeguards."[18] This claim ignores not only the fact that the *Non-Accounting Safeguards Order*[19] specifically cited and discussed the evidence proffered by AT&T on this very issue, but also that the *Order* applied longstanding rules banning joint OI&M services that were developed in numerous, related proceedings in which the Commission and other regulators analyzed in detail both the costs and benefits of

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[15] This is particularly true given Verizon's claims regarding the expected growth of GNI's services. Verizon June 24, 2003 *Ex Parte* at 12.

[16] Selwyn *Ex Parte* Dec. ¶ 22.

[17] Indeed, under Verizon's "absorption" theory, Verizon's other 272 affiliates could have sufficient capacity to handle GNI's OI&M. Thus, Verizon could potentially achieve all of its claimed savings simply by operating a single 272 affiliate rather that multiple 272 affiliates, as it currently does.

[18] *Ex Parte* Letter from Ann D. Berkowitz, Verizon, to Marlene Dortch, FCC, at 2 (CC Docket No. 96-149, May 15, 2003).

[19] *Non-Accounting Safeguards Order* ¶ 163 n.388.

structural separation.[20] In all of these proceedings, the prohibition against shared OI&M services rested on the fact that the BOCs controlled essential bottleneck facilities. Because Verizon does not (and cannot) seriously deny that it continues to control such facilities today, any departure from the Commission's existing rules and analyses would be unwarranted, arbitrary, and capricious.

In particular, well before the break up of the Bell System, the Commission was concerned that the Bell System would expand its dominance of local telephone markets to nascent "enhanced services" markets, as well as frustrate emerging competition for customer premises equipment ("CPE"). The Commission recognized that because many enhanced services could only be provided over last-mile facilities controlled by the Bell System, the Bell System had both the incentive and ability to leverage its local monopolies to gain market power in enhanced services markets. Likewise, the Commission was concerned that the Bell System would manipulate network architecture to frustrate CPE competitors. In order to protect competition and the public interest, the Commission initiated its landmark *Computer Inquiries* proceedings to study the conditions under which the Bell System would be permitted to participate in the enhanced services and CPE markets. And after "weighing" the "voluminous comments" on the costs and benefits of various options,[21] the Commission determined that the Bell System would be permitted to provide enhanced services and CPE only through a "separate subsidiary."[22]

In this regard, the Commission expressly rejected the Bell System's claims that "accounting" would be sufficient to prevent anticompetitive conduct. To the contrary, the Commission found that while accounting may assist in the detection of predatory behavior, it "cannot prevent" such behavior – only structural remedies could be effective.[23] Further, and of particular relevance here, the Commission expressly rejected the Bell System's claims that its subsidiary should be permitted to share OI&M services with its telephone operations to avoid increased maintenance and training costs. The Commission instead found that the imposition of such costs would be warranted on the grounds that the "manner in which enhanced services are provided and marketed are the two areas where the potential for anticompetitive behavior and misallocation of cost is great."[24]

Subsequently, in the wake of the break-up of the Bell System, the Commission initiated a new proceeding to study whether the *Computer Inquiries* obligations should be applied to the

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[20] *Id.* ¶¶ 163-164 nn.389, 390.

[21] *Computer II*, 77 F.C.C.2d 384, ¶ 84 (1980).

[22] *Id.* ¶¶ 190-200.

[23] *Id.* ¶ 210.

[24] *Id.* ¶¶ 238, 239.

Baby Bells. And again, after receiving voluminous, detailed testimony, the Commission reaffirmed its prior conclusions that

> the benefits to ratepayers and competition which can result from the requirements that CPE [and] enhanced services be offered through a limited form of separation outweigh the costs to the RBOCs of forming and operating through separate subsidiaries. Ratepayers will benefit not only through the reduction of common costs between regulated and unregulated operations, but also by the increased detection of any misallocation of costs between the two operations. In addition, competition should benefit since separate structure can reduce opportunities for anticompetitive conduct.[25]

Notably, the Commission re-imposed the separate subsidiary requirement on the BOCs' CPE operations despite the fact that the BOCs would be entering the CPE market with a zero market share.[26] And in so doing, the Commission rejected the request that "the separate subsidiary should be able to contract with regulated operations for the provision of engineering, installation and maintenance, and similar services," again finding that any costs imposed by this prohibition were warranted because of the ability of the BOCs to abuse "control over local exchange services."[27] In this regard, the Commission also observed that if it were to eliminate the prohibition on sharing OI&M services, it would be forced to engage in "excessive, costly and burdensome" auditing and monitoring of "day-to-day activities" of the BOCs in order to ensure that the BOCs were not using OI&M service as a tool for raising rivals' costs.[28]

In sum, contrary to Verizon's claims, the Commission's prohibition against OI&M sharing that it adopted in the *Non-Accounting Safeguards Order* was not only justified by the record before the Commission in 1996, but also by extensive, prior analyses of the costs and benefits of structural separation in general, and the OI&M prohibition in particular over a period of 20 years.[29] And while Verizon may be unhappy with the way in which the Commission weighed the costs and benefits of allowing a BOC to "share services" with its section 272

[25] *BOC Separation Order*, 95 F.C.C.2d 1117, ¶ 3 (1983).

[26] *Id.* ¶ 70.

[27] *Id.* ¶¶ 45-46, 69.

[28] *Id.* ¶ 70.

[29] *See Non-Accounting Safeguards Order* ¶ 163 ("[a]llowing a BOC to contract with the section 272 affiliate for operating, installation, and maintenance services would inevitably afford the affiliate access to the BOC's facilities that is superior to that granted to the affiliate's competitors"); *Non-Accounting Safeguards Second Order On Reconsideration*, 12 FCC Rcd. 8653, ¶ 12 (1997); *Non-Accounting Safeguards Third Order On Reconsideration*, 14 FCC Rcd. 16299, ¶ 20 (1999).

affiliate, there can be no claim that such an analysis was not conducted. In undertaking to determine the extent to which a BOC's incumbent operations could provide services on behalf of its 272 affiliate, the Commission did *not* simply mechanically apply these longstanding rules and prior analyses, but tailored them to the section 272 context. For example, whereas the Commission had previously prohibited a BOC from providing marketing services on behalf of its CPE and enhanced services affiliates, the Commission declined to impose such a requirement pursuant to section 272.[30] Likewise, the Commission decided that the "economic benefits to consumers from allowing a BOC and its section 272 affiliate to derive the economies of scale and scope" in "the sharing of administrative and other services," "outweigh any potential for competitive harm created thereby."[31] Because it remains true that Verizon controls essential bottleneck facilities – as was the case in 1983 and in 1996 – the Commission's rules and analyses prohibiting joint OI&M remain fully applicable today.

The OI&M Safeguard Is Necessary To Avoid Discrimination And Cost Misallocation. Since *Computer II*, the Commission has recognized that a BOC can use its network facilities (and services directly concerning those networks) as a powerful tool for discriminating[32] and that those facilities provide the BOC with unique opportunities to engage in cost misallocation of network services and related expenses.[33] Further, the Commission has determined consistently for the past 20 years that – while non-accounting safeguards (such as the ban on shared OI&M) that are necessary to prevent a BOC from using network services to harm rivals may impose some costs on the BOC – the only alternative would be intensive "regulatory involvement . . . to detect and deter" such abuses that would be even more "burdensome" than such "structural" separation.[34]

As Dr. Selwyn describes in his accompanying declaration, the Commission's historic precedent is well-founded. Indeed, Verizon's claims that its existing incumbent telephone operations would simply "absorb" the functions now performed by the personnel of its separate affiliates prove that it would in fact engage in improper cost misallocation absent the OI&M restrictions. For example, according to Verizon, forbearance from the shared OI&M restriction would allow it to eliminate 34 technicians employed by its affiliates, whose work would be absorbed by the existing incumbent telephone operations at a mere five percent of the costs incurred by the affiliate. But as Dr. Selwyn points out, if Verizon's incumbent telephone

[30] *Non-Accounting Safeguards Order* ¶ 168.

[31] *Id.*

[32] *See, e.g. Computer II* ¶¶ 238, 239; *Non-Accounting Safeguards Order* ¶¶ 158-166.

[33] *See, e.g.*, *BOC Separations Order* ¶ 70; *Non-Accounting Safeguards Third Order On Reconsideration* ¶ 20.

[34] *BOC Separations Order* ¶ 70; *see also Non-Accounting Safeguards Third Order On Reconsideration* ¶ 20.

personnel could in fact perform the incremental work of these 34 technicians with little added costs, then Verizon's incumbent telephone operations have excess capacity and are by definition inefficient.[35] Further, this excess capacity and "absorption" by the incumbent telephone operations would likely cause violations of the Commission's cost allocation rules.[36] As Dr. Selwyn explains, to absorb the affiliate's OI&M functions, the BOC might be required, for example, to undertake an expensive upgrade to ordering and provisioning systems that, after the upgrade, would be used to provide traditional local services and unregulated long distance services.[37] Under the Commission's cost allocation rules, however, Verizon could claim that the upgrade is a common cost that should be allocated on a "relative use" basis largely to its local service operations (even though the upgrade was not necessary to provide that functionality), thereby shifting the costs away from the competitive long distance operations and onto the monopoly local exchange services.

Dr. Selwyn also explains that the asserted benefits arising from forbearance and from integration of OI&M functions are, in fact, not benefits at all, but rather exemplify the superior access that Verizon's long distance operations would receive if OI&M functions could be shared.[38] For example, Verizon appears to claim that permitting shared OI&M could allow the BOC and its affiliate to bypass the established processes for ordering access services and allow the long distance operations to have direct access to the BOC ordering systems. But long distance carriers have repeatedly requested similar direct access, and claimed that the existing ordering processes are cumbersome and often unnecessary. Thus, if these cost savings could be achieved, then long distance carriers must also be given the same direct access (as section 272(e) requires). As Dr. Selwyn explains, the cost savings associated with this bypass therefore would not in fact result from actual integration efficiencies, but instead would be caused by the *elimination* of the contrived inefficiencies of the ordering process. On the other hand, if the BOCs are able to grant direct access only to their own long distance operations, and not to competing IXCs, then it is undeniable that allowing this sharing of OI&M "would inevitably afford access to the BOC's facilities that is superior to that granted to . . . competitors."[39] Thus, the ban on shared OI&M remains critical to prevent BOCs from discriminating in providing key long distance inputs like access and to ensure a level playing field between a BOC's long distance operations and those of unaffiliated competitors.

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[35] *See* Selwyn *Ex Parte* Dec. ¶ 9.

[36] *Id.* ¶¶ 14-19.

[37] *Id.* ¶ 18.

[38] *Id.* ¶¶ 20-21.

[39] *Non-Accounting Safeguards Order* ¶ 163.

Even The Cursory Biennial Audits That Have Been Conducted To Date Show Significant Discrimination And Cost Misallocation By The BOCs. The entire point of a structural prohibition like the ban on joint OI&M is to avoid excessive reliance on the "excessive, costly and burdensome" auditing of a BOC that would otherwise be required to detect and punish the cost misallocation and discrimination that the Commission has found "inevitably" would occur.[40] Thus, even if the audits conducted to date found no such misconduct, that would only demonstrate that the Commission's structural ban is effective – not that it is unnecessary, as Verizon claims. In order to avoid the need for detailed, "day-to-day" auditing and vigorous enforcement action to detect, punish, and deter cost misallocation and discrimination, the Commission should continue its OI&M prohibition.

Nevertheless, it is entirely appropriate to be concerned about the audits that have been conducted to date, because, as AT&T has explained in detail, they have been woefully inadequate even with the OI&M prohibition in place.[41] To begin with, the audit reports are not released until many months (or even years) after the audits are conducted. And the Commission has yet to impose any penalties on the BOCs as a result of the audits, despite significant findings of anticompetitive conduct. As a result, these biennial audits, at present, have no value whatsoever as a deterrent and could not possibly serve as an adequate "day-to-day" oversight mechanism that would be needed to ensure that the BOCs are not sharing OI&M in a discriminatory manner that raises rivals' costs.

Even beyond these significant shortcomings, the auditors failed to conduct the proper inquiries and gather the evidence necessary to test fully these BOCs' compliance with the key section 272 requirements. The audits were conducted pursuant to incomplete standards and procedures that were developed without the benefit of public comment and that have never even been publicly disclosed.[42] Indeed, with regard to OI&M sharing, the audit did not properly measure the BOCs' compliance even with the Commission's broad structural ban.

Specifically, under the General Standard Procedures the auditors were required to list services and employees in order to determine compliance with the OI&M safeguard. The Verizon 272 biennial audit of OI&M services, however, simply listed services as "Technical

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[40] *See Computer II* ¶¶ 70; *Non-Accounting Safeguards Order* ¶ 163.

[41] *See generally* Comments of AT&T Corp. on Verizon's Section 272 Compliance Biennial Audit Report (CC Docket No. 96-150, Apr. 8, 2002) ("AT&T Comments on Verizon 272 Audit"); Comments of AT&T Corp. on SBC's Section 272 Compliance Biennial Audit Report (CC Docket No. 96-150, Jan. 29, 2003) ("AT&T Comments on SBC 272 Audit").

[42] The General Standard Procedures used in the audit were established with BOC *but not public input*, and accordingly provided substantially less rigorous auditing criteria than the "Proposed Model" that was put out for public comment. *Proposed Model for Preliminary Biennial Audit Requirements*, 12 FCC Rcd. 13132 (1997).

Services" or "Telecommunications Services." These undefined categories are wholly inadequate to ascertain whether such services, rendered by the BOCs to the interLATA affiliates, constitute or include prohibited OI&M services.[43] Similarly, the SBC audit report indicated that: (1) SBC failed to provide the auditor with functional organizational charts for the Section 272 affiliate as of the audit date; (2) the auditor identified third party vendors who provided network planning and engineering to the Section 272 affiliate in the audit report only by letters A-L, making it impossible to verify whether these vendors were truly unaffiliated; and (3) SBC failed to disclose the individual locations where services were provided. If the audits could not assess compliance with the broad structural ban against OI&M, there is no hope that these BOC-designed audits would adequately detect BOC discrimination and cost misallocation when those services are shared and when detection of anticompetitive conduct would become far more difficult.

In this regard, even though the audits conducted to date were inadequate, they nonetheless shed enough light on the BOCs' practices to confirm pervasive discrimination with respect to the installation of access facilities – violations that could only be expected to grow worse if the OI&M safeguards were gutted. In one month, for example, Verizon provisioned high speed special access services for its affiliate in less than 10 days; non-affiliates waited more than 25 days.[44] That is no aberration – virtually *every* performance measurement disclosed in the audit reports shows that Verizon favored its affiliates over those affiliates' competitors.[45] Likewise, with respect to SBC, the audit revealed that with regard to completion of DS0 orders by the required due date, that SBC's affiliates received better performance in *each* of the last seven months audited – and the largest differences were in the last two months reported, confirming that SBC's performance was decreasing.[46] The data also show that SBC's return of firm order confirmations on DS1 and DS3 facilities were longer for SBC's rivals than for its affiliates in *all* 18 of the instances where the measure employed showed a performance difference. Likewise, for restoration of trouble SBC's competitors virtually always suffered longer delays than SBC's affiliates. For other measurements, too, SBC provided better service to its affiliates than to competing providers.[47]

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[43] *See* Auditor's Initial Biennial Report, Appendix A, Objective 1, Procedure 4 (CC Docket No. 96-150, June 11, 2001) (services also not listed in terms of *each* Section 272 affiliate). *See also* Auditor's Supplemental Biennial Report, Appendix C, Objective 1, Procedure 4 (CC Docket No. 96-150, Feb. 6, 2002).

[44] AT&T Comments on Verizon 272 Audit at 4.

[45] *Id.*

[46] AT&T Comments on SBC 272 Audit at 5.

[47] *Id.*

The Remaining Safeguards Are Insufficient To Detect And Deter Discrimination And Cost Misallocation. Verizon claims that other safeguards are sufficient to prevent discrimination and cost misallocation also have no merit. As explained below, these "conduct" provisions are not an adequate replacement for the OI&M "structural" separation.

Specifically, Verizon claims that section 272(e)'s non-discrimination requirement (and related "performance measures") is an adequate substitutes for the type of structural separation imposed by the OI&M (and other "operate independently") requirements. That is incorrect. Enforcement of such nonstructural, conduct requirements requires both detection of discrimination and an effective complaint process. However, by the time the complaint process has run its course, the damage to competitors and competition is done. And the BOCs have shown a willingness to breach and endlessly litigate enforcement of even their clearest legal obligations, as reflected in the Commission's imposition of a record-setting $6 million fine against SBC for having "willfully and repeatedly" violated the "plain" conditions of the SBC/Ameritech merger.[48] Similar repeated violations by the BOCs have led the California Public Utilities Commission, for example, to recognize that its "confidence in non-structural safeguards has waned significantly over the past years."[49] This Commission also has elsewhere stressed the need for structural safeguards, because BOCs can discriminate in a myriad subtle forms, and it is "impossible for the Commission to foresee every possible type of discrimination."[50]

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[48] *Forfeiture Order*, 17 FCC Rcd. 19923, ¶ 1 (2002). As the Commission concluded: "In state after state, throughout the Ameritech region, SBC force competing carriers to expend time and resources in state proceedings trying to obtain what SBC was already obligated to offer, causing delays in the availability of shared transport." *Id.* ¶ 24.

[49] Decision Granting Pacific Bell Telephone Company's Renewed Motion for an Order that it has Substantially Satisfied the Requirements of the 14-Point Checklist in § 271 of the Telecommunications Act of 1996 and Denying that it has Satisfied § 709.2 of the Public Utilities Code, *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, CPUC Decision 02-09-050, R. 93-04-003 *et al.* at 265 (Cal. PUC, Sep. 19, 2002). The California Public Utilities Commission has imposed fines against SBC of $27 million and $25 million – each records when imposed – for anticompetitive and unlawful conduct in California. *See* Final Opinion on Pacific Bell's Marketing Practices and Strategies, *The Utility Consumers' Action Network v. Pacific Bell* (U 1001 C), Case 98-04-004, D.01-09-058 (Cal. PUC, Sep. 20, 2001) ($25 million fine); Presiding Officer's Decision, *The Utility Consumers' Action Network v. Pacific Bell Telephone Company*, Case 02-01-007 (Cal. PUC, Sep. 27, 2002) ($27 million fine, per settlement).

[50] *SBC/Ameritech Merger Order* 14 FCC Rcd. 14712, ¶ 206 (1999).

Indeed, even for the states that have enacted rigorous "performance measures" with self-executing penalties, the BOCs continue to find it advantageous to provide competitors with poor network access. For example, according to the January 2003 report from the Public Utilities Commission of Texas ("Texas PUC") reviewing the effectiveness of the performance measures enacted in Texas, SBC has met the performance benchmarks set by the Texas PUC in only 6 out of 31 months for which data are now available.[51] As of July 2002, SBC had paid over $25 million in fines, an amount that would have been higher but for the fact that the Texas performance measure penalties cap payments in certain months.[52] Verizon too has been found to "provide[] special wholesale services in a discriminatory manner" by the New York Public Service Commission.[53] A recent report made to the New Jersey Board of Public Utilities by its auditors found over 100 instances in which Verizon was in violation of the Board's performance reporting guidelines and, as a result, there could be no assurance that Verizon was properly calculating its "incentive payments" or correctly crediting competitive carriers' bills.[54]

And with regard to essential "special access" performance standards at the federal level, there are none. The Commission has yet to act despite having requested comments almost two years ago as to the type of measures and penalties it should adopt.

Verizon also cites the obligation of the BOCs under section 272(b)(5) to enter into arms' length agreements reduced to writing and made available for public inspection. But the section 272 biennial audits highlighted the inadequacies of the public inspection safeguard. For example, the Verizon biennial audit found that nearly 40 percent of the Internet postings of contract summaries were insufficient, and nearly 20 percent of the non-compliant summaries had

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[51] *Scope of Competition in Telecommunications Markets of Texas*, Report to the 75th Texas Legislature, at 50 (Tex. PUC, Jan. 2003).

[52] *Id.* at 52.

[53] Opinion and Order Modifying Special Services Guidelines for Verizon New York Inc., Conforming Tariff, and Requiring Additional Performance Reporting, Opinion No. 01-1, Case OO-C-2051, *et al.*, at 6 (N.Y. PSC, June 15, 2001). This discrimination has not ceased. AT&T has recently discovered that Verizon was over-riding its OSS in order to provide its own retail customers far better installation dates than competitive carriers could obtain for their customers. *See generally* Letter from Harry M. Davidow, AT&T, to Dennis Taratus, New York State Dep't of Pub. Serv., *Discriminatory and Lengthy Provisioning Interval Disparity for UNE-Platform* (June 3, 2003).

[54] *See generally* Draft Report on the Review of Monthly Performance Reports and the Associated Incentive Plan Payment Reports Filed by Verizon New Jersey, Presented to New Jersey Board of Public Utilities by Liberty Consulting Group (June 7, 2003).

multiple errors.[55] In addition, there were numerous discrepancies between the affiliate's web postings and the written agreements, concerning such material terms as rates, descriptions of services, and indemnification of parties or personnel and their compensation.[56] Many service agreements were posted on the web with pricing and other material information listed as "to be determined."[57] There also were discrepancies between the posted transactions and those available for public inspection.

Further, the imputation requirement under section 272(e)(3), although an important safeguard, is clearly not a substitute for "structural" safeguards like the ban on OI&M sharing. At best, the imputation rule would protect competitors only from *price* discrimination, not discriminatory provisioning of access facilities. Moreover, because the Commission has yet to promulgate rules that fully implement section 272(e)(3), the Bells have been able to evade this provision by failing to impute costs to the separate affiliate that should be imputed.[58]

Finally, "price cap" regulation (at either the state or federal level) does not eliminate the risk of cost-misallocation. Even with price cap regulation, a BOC has incentives to shift costs from competitive services to regulated services in a manner that harms ratepayers, because price cap regimes almost universally provide a mechanism for re-adjustment of rates where rates depart significantly from costs. For example, as the expiration of the CALLS plan approaches, the BOCs have powerful incentives to shift costs in order to support higher exchange access price cap going forward. And even if there were "pure" price cap regulation with no sharing, earnings cap, or other re-adjustments, the BOCs will nonetheless obtain significant benefits by misallocating costs. For example, by manipulating the affiliate's costs to artificially low levels, the BOC can effect price squeezes on its rivals even as it appears to comply with imputation requirements. And by improperly inflating the costs of its local operations, a BOC can substantially boost prices for essential services like access and network elements that it provides to downstream rivals. In fact, as AT&T has demonstrated, price caps can *increase* the incentives

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[55] The Auditor in Objectives V & VI reviewed 839 web postings of contract summaries; 304, or approximately 37%, were non-compliant. Forty-four of these 304 non-compliant web postings had multiple errors. *See* Auditor's Initial Biennial Report, Appendix A, Objectives V & VI, Procedure 6.

[56] *See* Auditor's Initial Biennial Report, Appendix A, Attachment I, Table 2.

[57] *Id.*, Table 6.

[58] Reply Declaration of Lee Selwyn ¶¶ 21-24 (attached to Reply Comments of AT&T Corp., WC Docket No. 02-112, Aug. 26, 2002); *see also* Declaration of Lee Selwyn, ¶¶ 79-93 (attached to Comments of AT&T Corp., WC Docket No. 02-112, CC Docket No. 00-175, June 30, 2003).

for cost misallocation.[59] Under a price cap regime, a BOC has freedom to shift profits from one affiliate "pocket" to another without ever being forced to pass through "excess" profits to regulated customers. Thus, for example, Verizon could overcharge its section 272 affiliate for services it also provides to competing long distance carriers (and thereby set an unfairly high rate for competitors under section 272(e)), while separately undercharging the affiliate for services it does not provide to competitors, all without a concern about how such pricing would impact the rates it charged regulated customers.

Additional Non-Structural Safeguards. The OI&M safeguards, like structural separation generally, serve both to decrease the ability of a BOC to discriminate against rivals, and as a mechanism for the detection of such discrimination. As the Commission and other regulators have repeatedly held, no conduct or other safeguards could fully substitute for structural separation.

Regardless of the outcome of this proceeding, however, the Commission should take several important steps to strengthen conduct regulation of the BOCs. First, with regard to the detection and prevention of non-price discrimination, the Commission should adopt and enforce rigorous performance measures for special access services. Properly constructed performance measures would help identify attempts by the BOCs to use the absence of OI&M restrictions to discriminate in the provisioning of access. However, as discussed above, the BOCs have treated the penalties imposed by existing "UNE" performance measures adopted by state commissions as a mere cost of doing business. Accordingly, the Commission would need to impose automatic and substantial penalties for discriminatory performance. For these reasons the Commission should adopt the Joint Competitive Industry Group Proposal under consideration in the Performance Measurements and Standards for Interstate Special Access Services Proceeding, which is the result of an industry consensus among the entire spectrum of special access users regarding the performance measures, measurement calculations, business rules, exceptions, disaggregation levels and performance standards that are necessary to measure BOC performance in key areas.[60] Relatedly, the Commission should also adopt AT&T's proposals for reforming biennial audits to ensure that the BOCs are, in fact, complying with existing safeguards.

It is also necessary to prevent BOC abuse of customer preferred carrier choices, changes and freezes. Neutral administration of these customer choices would largely eliminate the regulatory burden in resolving preferred carrier disputes (whether between carriers or between

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[59] Reply Declaration of Lee Selwyn ¶¶ 35-36 (attached to Reply Comments of AT&T Corp., WC Docket No. 02-112, Aug. 26, 2002); *Ex Parte* Declaration of Lee Selwyn ¶¶ 43-44 (attached to *Ex Parte* Letter from David Lawson, AT&T, to Marlene Dortch, FCC (filed CC Docket No. 96-149, Nov. 15, 2002)); *see also* Declaration of Lee Selwyn, ¶¶ 97-103 (attached to Comments of AT&T Corp., WC Docket No. 02-112, CC Docket No. 00-175, June 30, 2003).

[60] *Id*. at 23-28.

carriers and customers and for all services, including local, intraLATA, or interLATA), would facilitate regulatory monitoring of carrier behavior with real-time data while reducing the need for monitoring, and would eliminate the need for additional regulation to address slamming, cramming, BOC discrimination, and consumer frustrations related to preferred carrier freezes. Indeed, this Commission itself has taken a step toward this solution, endorsing, in its preferred carrier freeze regulations, the use of an "independent third party" to confirm requests for preferred carrier freezes.[61] The Commission accordingly should create a mechanism to ensure that the BOCs no longer dominate customers' preferred carrier choices, changes and freezes.[62]

With regard to price discrimination, the only effective check on the BOCs' ability to price squeeze rivals is to remove the BOCs' ability to set above-cost access rates. As AT&T has explained elsewhere, there is a particularly urgent need for such action in the context of special access prices.[63] Since being granted "pricing flexibility," Verizon, BellSouth and Qwest have raised DS-level rates in *every* single one of their Phase II MSAs. These rate increases are far too large and one-sided to chalk up to "rate rebalancing" – the Bells have increased DS-level channel termination rates as much as *70%*. And, as IXC, CLEC, wireless, and broadband special access customers have all documented, the Bells refuse even to engage in serious negotiations over their special access rates.

The Bells' grossly excessive special access rates have extraordinarily far-reaching anticompetitive consequences. Special access is a critical input to *all* suppliers of wireless, broadband, and long distance services (and, because of the use and commingling restrictions, suppliers of local services as well). The Bells' inflated special access rates therefore not only increase the rates that end users must pay for all of these services, but give the Bells' wireless, broadband, and long distance affiliates an artificial competitive advantage. Swift action to constrain special access rates to just and reasonable levels will, accordingly, bring direct and very substantial benefits to consumers and competition in all communications markets.

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[61] 47 C.F.R. § 64.1190(d)(2)(iii); *see also* 47 U.S.C. § 251(e)(1) (mandating a similar approach for administering telecommunications numbering).

[62] Comments of AT&T Corp., at 29-39 (CC Docket No. 02-39, May 10, 2002).

[63] *See generally* AT&T Petition for Rulemaking (RM No. 10593, Oct. 15, 2002); AT&T Reply Comments (RM No. 10593, Jan. 23, 2003).

Sincerely,

/s/ C. Frederick Beckner

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